GTE's proposed structure represents only limited change from the current basket structure. The proposal would simplify the existing plan by reducing the number of service categories and subindices, and would permit LECs to adjust relative rates over time without resulting in competitive harm. Also, as discussed *supra*, GTE's proposed structure would accommodate zone pricing for most of the major access rate elements.

Most commenters opposing additional LECs pricing flexibility advocate the retention of the existing basket structure until a competitive showing is made, or until competition has reached a certain level.[51] AT&T (at 52) advocates the creation of a new service category for LIDB and the separation of call completion services into two categories (operator-related and directory assistance-related), citing the potential for rate cross-subsidization if categories are combined. On the other hand, MCI (at 20) agrees with GTE's approach that all operator services should be placed in one category. Finally, CompTel (at 35-36) claims that consolidation of the existing DS1 and DS3 subcategories would harm competition.

As GTE stated in its Comments, the LEC price cap plan should evolve toward a more optimal structure which allows reasonable changes in relative rates to occur over time, as the Commission intended when it first adopted the price cap plan. The current LEC plan is overly complex and in some cases, the creation of subcategories for single rate elements severely restricts the ability of LECs to make any meaningful rate changes in response to market conditions.

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51 Time Warner at 23, CompTel at 33, Sprint at 22.

GTE believes its approach is reasonable. It would place operator services in a separate category under the Switching Basket, which would accommodate the concerns of AT&T and others that operator services be placed in its own category. Further, LIDB and 800 Data Base would also be combined into a category under the Switching Basket, reflecting the similarities of these services. This would provide adequate protection from excessive rate changes for IXCs that rely on these two services without further complicating the price cap plan.

GTE believes it is time for the Commission to remove the artificial distinction between DS1 and DS3 high capacity services and place all digitally-based services in a single category. Transport services at digital bit rates are close substitutes for one another. There is absolutely no need for separate DS1 and DS3 subcategories based on current market conditions for these services. This structure also would easily accommodate the introduction of new digital services, such as SONET-based transport offerings.

The original justification for separating DS1 and DS3 services into separate categories, *i.e.*, the protection of DS1 customers from rate increase to offset DS3 rate reductions, is no longer valid. CompTel (at 35-36) bases its claims on an artificial view of the market which is not supported by the facts. CompTel posits, first, that there are different levels of competition for DS1 and DS3. In fact, any CAP that offers DS3 also offers DS1. The differences in the degree of competition are related to geography, not to the product differentiation between DS1 and DS3. If an alternative provider is offering service in a given area, then both speeds will be available.

CompTel's artificial market view also assumes that there is one set of services that is purchased primarily by large IXCs, and a second set of services that is purchased by smaller IXCs. LECs, according to CompTel, will then exploit this difference by raising prices to small IXCs in order to fund reductions to large IXCs. In fact, no such distinction exists among services, and no such strategy is available to LECs. Every LEC access service is purchased primarily by large IXCs. For example, during the third quarter of 1995, eighty per cent of all DS1 entrance facilities were provided to the largest IXCs in GTE serving territories. Therefore, GTE cannot discriminate between large and small IXCs by varying rates for DS1 and DS3. If GTE raises its DS1 price, it will be raising it primarily to its larger IXC customers. As explained *supra*, if those customers have alternatives for DS3 service, they will have alternatives for DS1 service as well. Further, the proportion of demand generated by small IXCs is so limited that raising rates to those customers -- even if GTE could discriminate against them -- would not fund any significant reduction in rates to larger IXCs.

In sum, the market distinction CompTel draws between DS3 and DS1 is not valid, and the hypothetical strategy CompTel anticipates would not make good business sense for a LEC. CompTel's view of the world is an egocentric one; it analyzes the market based on what its members buy, rather than on the demand the LECs actually face for what they sell.

Over the past several years, GTE has constructed service offerings that accommodate all sizes and types of IXCs and end user customers. For example, GTE's MetroLAN transport services are made equally available to both large and small access customers at DS1 quantities. The flat-rated nature of MetroLAN (versus a per mile structure) makes it more attractive to some smaller customers. GTE has also introduced a number of DS1 term and volume discount payment plans for special access which are designed to accommodate both large and small IXCs as well as end users.[52] GTE has also placed into effect discount plans for DS1 switched access entrance facilities in a number of states. In addition, rapid development and use of SONET technology is prevalent in today's networks. Deployment of SONET technologies results in lower per unit transport costs to IXCs irrespective of whether the traffic transiting the network is at a DS1 or DS3 level.

In summary, GTE urges the Commission to further streamline the existing price cap basket structure to reduce its complexity. GTE believes that the structure it has proposed will achieve these goals while providing adequate protection against cross-subsidization and "price squeezing" concerns.

F. Lower Service Band Index and Rate Reductions

In the *SFNPRM* (at ¶75), the Commission concludes that the elimination of the lower service band limits "will result in more efficient pricing, enhance competition, and will not adversely affect ratepayers." In order for the price cap plan to provide consumers with substantial benefits that could be realized from lower prices, it is necessary to remove any artificial barriers that prevent this from occurring. GTE supports the Commission's proposal to eliminate the lower service band limits in the price cap plan. However, GTE is strongly opposed to the Commission's proposal (at ¶48) to apply a one percent upper limit to service categories in which a LEC "makes price reductions pursuant to the pricing flexibilities in this Second Further Notice."

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52 *See* GTOC Tariff FCC No. 1 -- DS1 Term Payment Plan, Section 5.6.14; DS1 Optional Payment Plan, Section 5.6.12; and DS1 MetroLAN Transport, Section 5.6.16.

AT&T (at 39) supports the proposal to eliminate the lower banding constraint, only if LECs are prohibited from increasing rates in other service bands by excluding price reductions below the band from the API calculation. AT&T also supports the one percent upper SBI limit. CompTel (at 32-33) contends that any downward pricing flexibility be tempered with a requirement to lower rates in other service categories using the same transmission facilities and that an upper band of zero be established for those LECs taking advantage of such flexibility. MCI (at 7-8), however, opposes any additional downward pricing flexibility, insisting that LECs should continue to support rates with an average variable cost showing. Finally, Sprint (at 21) supports removing the lower pricing band on the condition that LECs be constrained in their ability to subsequently raise such rates.

GTE believes these proposals would seriously dampen the benefits that price cap regulation is intended to achieve. The price cap plan should not penalize LECs for reducing rates. As GTE explained in its Comments (at 32-34) the proposal to impose a one per cent upper band would create a strong disincentive for LECs to reduce rates.[53] In fact, if this proposal were adopted, the Commission's stated objective in eliminating the lower bands would not be met, since the one per cent upper band would create a far stronger disincentive to reduce rates than the lower banding limits do today. GSA

53 It is important to note that the issue here is not simply the LEC's ability to raise the particular rate it had reduced. The Commission's proposal would also limit the LECs' ability to make other rate adjustments that the LEC might have made in any event. Perhaps most importantly, it would affect the rate at which SBI limits would become binding again in future years, as the PCI moved over time. Thus, a LEC that reduced rates in year 1 might be rewarded for this "good" behavior by being forced to make additional reductions in year 3. *See* GTE Comments at n.43.

(at 7-8) also agrees that the one per cent upper band proposal would deter LECs from reducing rates.

The Commission has previously considered a mechanism which was intended to make rate reductions permanent as a means of discouraging predation. In its *OCP Notice*, it sought comment on whether AT&T should be required to maintain any discounts it offered for some minimum period of time.[54] AT&T argued then, as GTE does here, that the inability to withdraw a price cut would deter a carrier from offering such reductions. The Commission accepted this argument, and declined to adopt any prohibition on subsequent rate increases.[55]

The Commission should also consider that relative rate adjustments, both increases and reductions, are necessary over time to establish efficient rate relationships. In fact, rate deaveraging, which may involve some rate increases, may be the only way that competition can realistically extend to rural areas. A one percent upper band limit does not allow sufficient scope for relative rate adjustments. The objective of the price cap plan is to mimic the effects of competition. As GTE noted in its Comments (at 33), markets generate information by trial and error, as firms operating under uncertainty experiment with rate changes, new service offerings and promotions. A requirement that attempts to "lock in" rate changes forever will prevent the market from generating information in this way. Further, precisely because the

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54 *See OCP Notice* at ¶¶50-52.

55 *OCP Order* at ¶¶85-86.

effect of any rate change is uncertain, such a requirement would deter LECs from undertaking potentially beneficial changes.

It is also not clear from the *SFNPRM* how the one per cent upper band proposal would be administered. The Commission does not explain how it would distinguish rate reductions made pursuant to the pricing flexibilities in the *SFNPRM* from those that were not. One possibility would be for the one per cent limit to be triggered by a movement of the SBI below some lower threshold. This is not significantly different from the current lower banding limit, except that the "penalty" to the LEC for exceeding the lower band is different. As explained *supra*, it is more severe. This approach will either deter reductions altogether, or create an incentive to find other rates within the SBI which can be raised to offset the reduction. Alternatively, the one per cent limit could be triggered by individual price movements. This again raises the problem of identifying which rate reductions would cause the one per cent limit to be imposed. Further, since the one per cent limit would apply to all of the rates in the SBI, it would create an even greater deterrent to rate reductions. A reduction in one element could trigger an additional constraint on several other elements. This would especially deter reductions in elements whose revenue weight is small relative to other rates in the SBI. In short, there is no reasonable way to administer the proposed one per cent limit.

AT&T (at Appendix B) presents an analysis that demonstrates how LECs could use additional downward pricing flexibility to "game the headroom potential." However, AT&T's numerical example of the removal of lower SBI limits contains numerous errors and its example of cross-subsidy potential is exaggerated. The ability to raise the price of one element in one location to offset reductions in another is dependent on a number of factors within the current plan, such as relative revenue weights and service mix.

AT&T has conveniently used index values, rate change assumptions and exaggerated revenue distributions that results in extensive potential revenue shifts. However, for those LECs that have historically priced consistently below the cap, the possible revenue shifts to be gained by such an effort are not so great.

In GSA's view, the concerns that LECs will make significant corresponding increases in other rates is overstated. As GSA (at 7-8) states: "Any LEC must know that it stands little likelihood of eliminating competitors through below cost pricing and the likely effect of above cost pricing will be to hasten the challenge of competitors." GTE agrees. Concerns over corresponding rate increases are not demonstrated by the facts. GTE, more than any other price cap LEC, has reduced access rates under the price cap plan, including below-band filings for both switched and special access rates. GTE has not made widespread rate increases while, at the same time, proposing rates that are below the lower banding limitations.[56]

The lower banding constraint was first imposed to address concerns over the possibility of predation. As GTE has suggested in the past, cost floors are an effective means of dealing with such concerns.[57] The lower banding constraint is a useful way of applying such a floor. It establishes a "zone of reasonableness" for rate reductions, so that the Commission does not need to seek cost floor information for every proposed reduction, but only for those which fall outside the lower band. Nonetheless, it does impose a cost, since it creates a deterrent to rate reductions which would benefit

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56 In its Comments (at 29), GTE listed the reasons why predation is unlikely to be a viable strategy for any LEC. *See also* Schankerman at 8-9.

57 *See, e.g.,* Schankerman at 10.

consumers. While, as GTE has demonstrated, it is possible for a LEC to make the showing required for a below-band filing, clearly the LEC would prefer not to do so, and may avoid rate proposals which would require such a showing.[58]

The proposal in the *SFNPRM* to remove the lower band constraint correctly assumes that lower bands deter price reductions and the benefit of such rate reductions outweighs any possible risk of predation.[59] GTE agrees with GSA that the risk of predation in LEC access markets is small. The Commission should find that first-order benefits to consumers, in the form of lower prices, are far greater than the remote possibility of competitive harm from predation. Further, as the *SFNPRM* (at ¶83) notes:

> [T]he upper band service limit, at five percent above the LEC's new lower rate, and the price cap itself would remain as disincentives to predatory pricing if the lower service band limits were to be eliminated.

Consistent with this conclusion, the Commission should remove the lower banding constraint without imposing any new upper band limits.

If, however, the Commission remains concerned that removing the lower bands could raise a significant concern with respect to predation, then it should simply retain the lower banding constraints. The lower band limits are more effective, and less costly, protection against the possibility of predation than the proposed one per cent upper banding constraint. If adopted, the one percent proposal would create an even

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58 MCI's claim (at 7) that no below-band filings "have ever tested the lower boundary of average variable cost" is simply not true. GTE has met this standard in its below-band filings.

59 *SFNPRM* at ¶83.

greater deterrent to price reductions than the current lower bands, thereby defeating the purpose of eliminating the lower bands.

G. ICB and Contract-Based Tariff Filings

The *SFNPRM* proposes to further restrict the LEC's abilities to provide services to customers under an individual case basis ("ICB") approach. In its Comments, GTE urged the Commission not to unreasonably restrict the use of ICB tariffs and to further allow contract based tariffs under baseline price cap regulation. ICBs are a reasonable and practical tool to respond to customer requests for unique service arrangements. To further restrict the use of ICB arrangements would deter LECs from meeting legitimate customer needs, and correspondingly, would deter customers from requesting non-standard service arrangements from LECs.

Not surprisingly, most IXCs competitors support the retention and strengthening of the ICB restrictions.[60] Speaking from a customer perspective, GSA (at 8-11), on the other hand, urges the Commission to allow LECs to continue to file ICB tariffs and opposes the placement of any time limits on their effectiveness.

The inevitable outcome of adopting a more restrictive ICB policy would be to provide LEC competitors with an unfair advantage. If restrictions are imposed as to the type of service for which ICBs can be filed or the length of time an ICB rate could remain in effect, customers would have little incentive to come to a LEC with an ICB request. This would provide the LEC's competitors with a guaranteed market for such

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60 *See, e.g.,* CompTel at 30, MCI at 14, Time Warner at 16-18.

customers, since competing access providers are free to offer any type of custom-designed service arrangements for customers and for any length of time.

GSA observes that the Commission's requirement that ICB service offerings must not be "like" any other previous offered service may often be misunderstood. The ICB service may use the same technology and provide the same functions as a generally tariffed service; however, it may differ in many respects as to the arrangement of service component parts and functions. Therefore, GTE agrees with GSA that the test of "unlikeness" must be extended to system architectures, as well. Customer efforts to customize their telecommunications services would be frustrated if they were forced into taking the "standard" tariff arrangement, or nothing at all.

The *SFNPRM* also proposes to allow LECs to file contract-type tariffs for those services under streamlined regulation. GTE believes that LECs should be able to respond to a customer's Request for Proposals ("RFP") by the development and filing of a contract-type tariff. GTE proposes that under baseline regulation, LECs be allowed to file contract based rates if (1) customers have requested bids for services under and RFP, and (2) two or more telecommunications service providers have responded to the RFP. Once filed, contract tariffs would be subject to a cost support showing.

The LECs' competitors (CompTel 40, MFS 8) are opposed to allowing LECs to use contract-based pricing and some (MCI at 34) would even deny use of contract tariffs in the context of streamlined regulation. As in the case of unique service offerings filed under an ICB tariff, restricting a LEC's efforts to provide such services to customers that issue RFPs unfairly advantages other service competitors and, ultimately, could deprive customers of the ability to obtain the lowest-cost, highest quality service available. Provision of services via a RFP/contract process is an accepted and normal practice in both the public and private sectors of the economy.

GSA, a prominent purchaser of telecommunications services through the RFP process supports the use of contract tariffs. As GSA notes: "If a contract is the result of a competitive procurement in which multiple bidders submitted viable proposals, the Commission can assume that all services provided under that contract are subject to substantial competition, and qualify for streamlined regulation."[61] According to the GSA, it is the procurement process itself that determines whether competition exists for that service. Clearly, if multiple service providers respond with valid bids to an RFP that meet the service standards and qualifications of the RFP, the only conclusion one could reach with respect to that service is that it is competitive. Accordingly, GTE requests that the Commission allow LECs to file contract-based tariffs that are a result of an RFP process under baseline regulation.

H. Restructured Services

The *SFNPRM* proposes to adopt shorter notice periods for restructured services, an effort GTE supports. GTE believes that a 14-day notice period is reasonable and is consistent with the filing period for within-band rate changes. Both types of tariff filings require the same type of supporting data (*i.e.*, changes in indices, proof of compliance with the PCI).

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61 GSA at 16. Under GSA's proposal, LECs may be required to submit certification statements explaining the circumstances under which the contract was developed and possibly statements from the end user customer that competitively viable offers were received from other suppliers. GTE agrees that these procedures are reasonable.

Some commenters oppose this shortened review period, stating that restructured services "demand careful review" (AT&T at 26) or should be accompanied by *increased* cost support (Ad Hoc at 12). These comments, however, ignore the fact that for the most part, restructures of existing services are made to better accommodate customer demands and market trends. As such, GTE's restructure filings are rarely challenged. In addition, rate and service restructure filings made under the existing price cap rules do not require a separate cost support showing. The original service will have been adequately cost supported at the time the service was initially filed. Therefore, submission of additional cost data, as suggested by Ad Hoc, is unnecessary.

Commenters also fail to distinguish restructure proposals which would establish new rate elements from those which simply adjust prices within price cap limits. The *SFNPRM* proposal to reduce notice periods applies to the latter; it assumes that either a waiver is not required, or that one has been granted, Absent the waiver process, the price cap support submitted with a restructure is, as the *SFNPRM* notes, straightforward, and review of that support should not require a long notice period.

GTE recommends that the Commission should also consider ways to improve the waiver process as it applies to restructure filings which involve new rate elements. This could take the form of the petition proposed for new services in the *SFNPRM,* as long as the Commission maintains a specified time period within which it would respond to such a petition.

IV. THE COMMISSION SHOULD ESTABLISH A FRAMEWORK FOR STREAMLINING LEC ACCESS MARKETS BASED ON CLEARLY ESTABLISHED CRITERIA.

In the *SFNPRM* (at 2), the Commission announced its intention to establish a regulatory framework which would adjust the degree of regulation to be applied to LEC interstate access services to match the degree of completion in each market. GTE has long urged the Commission to develop such a framework.[62] The framework proposed in the *SFNPRM* would include three stages. In the first stage, as discussed *supra*, the Commission has proposed "baseline" reforms to its price cap plan which would yield benefits even in markets where the presence of competition had not yet been demonstrated. In the second stage, the Commission proposes to streamline its regulation of access markets where competition has been shown to be sufficient to discipline LEC pricing decisions. In those markets, the *SFNPRM* proposes to remove LEC interstate access services from price caps. In the third stage, LEC access services would qualify for nondominant treatment.

A. A framework should be established which will adapt to competition as it develops.

Several parties have suggested that the Commission is premature in considering the second and third stages.[63] It is suggested that competition is unlikely to develop soon in access markets. The *SFNPRM*, however, recognizes that access competition has already begun.[64] GTE has discussed *supra* the growth of competitive alternatives. GTE submits that several of the relevant access markets within GTE's serving areas would meet any reasonable competitive criteria today.[65]

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62 *See* GTE's Comments, Reform of the Interstate Access Charge Rules, RM-8356, filed November 1, 1993.

63 *See, e.g.*, AT&T at 5, Sprint at 25.

64 *See, e.g.*, *SFNPRM* at ¶5.

65 In some GTE areas, customers representing more than 75 percent of all interstate access demand -- including both switched and special access, and both large and small end user customers -- have alternative sources of supply available today. This analysis is based on networks which are already in place,

The matter under consideration in this proceeding, however, is not whether any particular access market is competitive; rather, it is whether a framework should be established which will adapt to competition as it develops. The Commission's proposal is timely for a number of reasons. First, relaxation of price cap regulation in those markets which are competitive will benefit consumers by allowing the incumbent to compete more vigorously. Second, even in those markets which have not yet been shown to be competitive, the establishment of a framework in advance, with clearly stated parameters, will establish reasonable expectations for all market participants concerning the ground rules that will govern competition. This will allow both the incumbent LECs, current competitors and potential entrants to base their investment and market entry decisions on more accurate price signals. As the *SFNPRM* notes (at 25) inefficient entry will be promoted by "the expectation that existing price relationships will be maintained." Further, an adaptable framework will encourage efficient investment by the incumbent, as well as by entrants. A LEC may be deterred from making efficient levels of investment in new network capabilities if the LEC is uncertain about whether it will be allowed to compete effectively in the event of entry. An ad hoc, "wait-and-see" approach, advocated by some commenters, cannot provide the correct signals to the market.

Schankerman (at 11-13) presents this concern in the context of a simple analytical model in which firms play a two-stage strategic game. In the first stage, all potential suppliers -- both incumbents and entrants -- make their entry decisions,

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and which can reach the end-user locations which generate the demand without reliance on GTE's network. The analysis is therefore conservative, since it does not consider additions to those networks, potential entry or resale of GTE's services.

choosing where and how much to invest, and what technologies to use. Some of this investment is sunk, and cannot be fully recouped upon exit. In the second stage, the firms who have entered in the first stage compete with one another on the basis of price, quality, customer service, and so on. Since the entry decision is based on expected profits, it will depend on the competitive conditions the firm expects to face in the second stage. Therefore, any regulatory restrictions that constrain the competitive situation in the second stage will affect the entry decisions in the first stage.

As the *SFNPRM* acknowledges, asymmetric regulation of the LECs will send incorrect price signals and encourage uneconomic entry. The *SFNPRM* seeks, correctly, to minimize this distortion by eliminating features of its baseline regulation which contribute to price distortions, but which are not necessary to protect consumers. While some baseline price cap regulation may be needed to constrain LECs in markets where competition cannot yet do so, entry decisions made on the basis of such regulation will be distorted. The best solution to this problem is for the Commission to adopt clear rules in advance which spell out how regulation will change when entry does occur. If participants -- both incumbent LEC and potential entrants -- can predict with some confidence how regulation will be relaxed in the second stage of Schankerman's game, then the distortion of entry decisions caused by the need to maintain price cap regulation in the first stage will be minimized.[66]

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66 ALTS claims (at 11) that competitors cannot be "lured" into making incorrect entry decisions. However, if the Commission does not establish a clear framework for streamlining, and instead examines changes in access markets on an ad hoc basis over time, then each firm will be uncertain as to how, or when, the Commission will reduce its regulation in each market. The comments in this proceeding make it clear that many parties have an interest in maintaining pricing umbrellas as long as possible.

Such an adaptive framework cannot be "premature," as some parties have suggested. Streamlining would only be granted when the criteria established by the Commission had been satisfied. In markets where this has already occurred, adoption of the framework would provide immediate benefit in terms of more effective competition. In markets which have not yet met the criteria, no harm can be done, since streamlining would not occur. Nonetheless, adoption of the framework will send more accurate price signals to all participants, encouraging efficient levels of investment by new entrants and LECs. If the Commission defers action, both of these benefits will be lost. In fact, the Commission has already waited too long, since considerable investment has already been made in many access markets.

Another important consideration is the fact that access markets, because they are localized geographically, are more numerous than long distance markets. As the Commission itself has noted in the past, competition in these markets is also likely to develop more rapidly than it did in the long distance market. It will, therefore, be necessary to evaluate more markets, over a shorter period, than the Commission did previously in its assessment of AT&T. If the Commission attempts to deal with these markets on an ad hoc basis, in separate proceedings, it will face a heavy administrative burden, and will find it difficult to make its decisions in a timely manner. By adopting clear rules for an adaptive framework now, the Commission will equip itself to deal with this transition in a more efficient manner, and avoid the need for repeated proceedings.

B. The Commission should define the geographic dimension of relevant markets by establishing reasonable guidelines for grouping wire center serving areas.

The *SFNPRM* (at ¶120) suggests that the current density pricing zones could be used as the relevant markets for purposes of applying criteria for streamlining. GTE argued (at 48-52) that while a definition based on wire centers was reasonable, the current zones do not represent useful groupings of wire centers for this purpose.[67] GTE proposed instead that LECs should group wire centers into relevant markets based on simple guidelines. The wire centers in each group would be required to be contiguous, and some part of each wire center would have to be included in an addressable "footprint".

Most commenters agreed with GTE that the current density zones do not represent a useful basis for defining relevant markets.[68] AT&T (at 14 and Bernheim Appendix A at 7) argues that the geographic market should be defined narrowly, since access customers in one area have only a limited ability to substitute access services from another area. GTE agrees generally that LEC access markets are limited geographically; however, the size of the relevant area will vary greatly from one area to another. The Commission must develop a market definition that accommodates these differences, yet is also simple enough to administer.

Bernheim explains (at 10) that if the area defined as the relevant market is too large, and if the LEC is able to make a competitive showing for the entire area, LEC customers in the portion of the market area where alternatives were not actually

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67 Nor should the Commission attempt to re-draw the zones to produce more reasonable relevant markets. This would compromise the usefulness of the zones for their original purpose of capturing differences in density.

68 *See, for example*, AT&T at 13-14, SWB at 56-58, Time Warner at 49. SWB provides (at Attachment D) maps of its zones in Missouri, showing that zones are both too large and too small. The area in St. Louis where competition is prevalent includes wire centers from all three zones. But each of those zones also includes areas in other parts of the state where little competition exists, and which are clearly too far from St. Louis to permit alternative supply to be substituted within the area.

available could lose necessary price cap protection. GTE agrees; this is why proposals from some commenters to adopt large standard areas, such as LATAs (Cox at 4, Time Warner at 49) should not be adopted. A further disadvantage of a large area is that, if the LEC is *not* able to satisfy the Commission's criteria for the entire area, it would be unable to respond to competition in the portion of the area that was competitive.

However, if the defined area is smaller than the actual market, the LEC would not, based on a single showing, be able to respond to competition throughout the relevant market. Further, very small standard units would require the LECs to submit many showings. As the *SFNPRM* notes, this would create an administrative burden for the Commission. In general, the relevant market cannot be smaller than the competitive "footprint" -- the area in which alternative sources of supply are available.[69] The size of the area where customers can obtain alternative supply is limited not so much by an individual customer's ability to purchase access in one location and use it in another, as AT&T suggests (at 14), but by the geographic reach of the competitors serving an area. If the competitor will supply access at a customer's location, the customer does not have to "import" access from another point within the market.

GTE submits that the objective in defining a relevant geographic market should be to distinguish areas which are competitive from those which are not.[70] Rather than

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69 Bernheim mistakenly suggests (at 7) that a customer as close as a block away from a CAP fiber backbone would not be able to obtain service from the CAP. This ignores the fact that the CAP can extend a link from its backbone to reach the customer. GTE (at 68) proposes that the competitive footprint be based on carriers' own reporting of the areas in which they provide service.

70 MCI claims (at 32) that: "If the LECs are allowed pricing flexibility in only those wire centers where they face competitors, they will be able to fund these decreases by raising rates in other wire centers where they do not face competition." MCI is wrong. By excluding less competitive wire centers from the

define an arbitrary area, such as a LATA or a zone, the Commission should adopt a flexible approach which seeks to include areas that are likely to be competitive, and exclude those which are not. GTE's proposal would accomplish this by defining the market area as a group of contiguous wire centers touched by a competitive footprint. This approach is based on the smallest practical geographic unit, the wire center. It assembles those wire centers in which at least some competitive supply is available; this provides assurance that the resulting area will not be too large.[71] By allowing the LEC to group wire centers, it assures that the area will not be too small, and reduces the number of relevant markets to a level that the Commission can reasonably administer. Because the approach is flexible, it would allow a relevant market to be as small as a single wire center, and as large as a LATA -- so long as the guidelines for grouping wire centers are met.

C. Relevant markets should be based on a combination of the geographic, service and customer dimensions.

GTE argued (at 57) that relevant markets should be defined on the basis of three dimensions: geographic, service and customer. A relevant market would comprise a logical grouping of substitutable services provided to a given customer set in a given geographic area.

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relevant area, the Commission would leave them under price caps, which would prevent the LECs from raising rates in those wire centers to fund rate reductions.

71 Bernheim (at 9-10) suggests that the problem of using a larger area could be mitigated by requiring the LEC to charge uniform rates across the area. See also, Time Warner at 44. Unfortunately, this requirement would also raise the cost to the LEC of responding to competition in the relevant market, since it would also have to reduce its price in the rest of the large area. This is precisely the problem with the current study area averaging requirement. Since GTE's proposal would protect against defining too large an area, it would obviate the need for a uniformity requirement.

GTE noted (at 55-56) that the opportunities for substitution among access services depend, in part, on the characteristics of the end-user location to which access is being provided. For a large end user, a direct connection to an interexchange carrier would allow LEC switched access to be replaced by a combination of special access (from the LEC, a CAP or another vendor) and switching (at the IXC's POP, or by another access provider).[72] Further, alternative supply may be available to large customers in a given area, but not to small customers. Bernheim agrees with GTE on these points. He recognizes (at 4) that "competition might develop in the provision of switching services to large customers, but not in the provision of these same services to small customers." With regard to service substitution, he points out (at 5):

> The proposed approach fails to capture the possibility of customer substitution towards technologies that do not require directly comparable service components. Imagine that a final service, A, requires the use of an intermediate service that is supplied by a single vendor. The vendor is an apparent monopolist -- entry is blockaded, so that no other firm can produce the intermediate service. Although one might be tempted to conclude that the vendor of the intermediate service has market power, this conclusion is premature. It is possible that there is some other final service, B, that provides a close substitute for service A, and that makes no use of anything even remotely similar to the monopolized intermediate service. In that case, the availability of service B may provide an effective check on the exercise of market power over service A. If so, it also provides an effective check on the exercise of market power over the intermediate service in question.

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72 *See also* Schmalensee and Taylor, Pricing Flexibility for Interstate Carrier Access Services, ("Schmalensee and Taylor II"), attachment to USTA Comments at 23: "By the Merger Guidelines market definition method, then, customers having sufficient volume to support dedicated access services should be treated as a separate market from small customers (those with low volumes of traffic) that are restricted to switched access."

In this case, a service arrangement based on a combination of CAP transport and IXC switching can provide a service B which is substitutable for that provided using LEC switched access, even though the alternative access provider may not offer a service which is exactly like LEC switched access. Nonetheless, the availability of arrangement B effectively checks the exercise of market power over LEC switched access, the intermediate input to arrangement A.

Because such substitution among service arrangements is possible, GTE recommends that relevant markets be defined in terms of the logical groupings of services which can be used in these service arrangements. (GTE at 57-61) However, because large customers may have different opportunities to substitute alternative service arrangements than small customers do, it may be necessary to place the logical grouping of services provided to large customers in a separate relevant market from the services provided to small customers.

Bernheim also argues (at 5) that the relevant market should include all intermediate services in the "vertical chain", as well as all of the final services that use the intermediate services. This is clearly not correct. First, the final services, such as toll, are not substitutable for the access services in question. Second, the LECs do not have market power for most of the final services, such as interLATA services, and are not even allowed to provide them today. Third, as Bernheim himself demonstrates, if an alternative supply is available which does not depend on the LEC at any point in the vertical chain, the LEC cannot exercise market power. This would be the case if a relevant market met the addressability standard proposed by GTE, based on the availability of service from facilities-based providers.

Finally, Bernheim does not demonstrate how, even if the LEC had market power over some services, it could acquire market power over final services that use its interstate access services at some point in the vertical chain. The Commission's policy on expanded interconnection, as well as the nature of interstate access services, makes this unlikely.[73] In fact, Bernheim is unable to provide a plausible example of how this would occur. He suggests (at 20) that if switching became competitive, the LEC could exploit its market power over loops by degrading the quality of complementary loops through discriminatory interconnection, and then by raising the price of its switching. However, the Commission has already established its rules concerning expanded interconnection, which provide for added regulatory scrutiny of expanded interconnection rates and terms. These rates, which are already out of price caps, would not be affected by the streamlining proposed in the *SFNPRM*. Further, once interconnected, competitors purchase the same access services, at the same tariffed rates, as do other customers. There is, thus, no opportunity for LECs to manipulate rates for loops and switching in such a way as to discriminate against interconnectors.[74]

Time Warner suggests (at 42) that the Commission's definition of relevant markets should be based on the extent of the market the LEC serves with common or shared facilities. Neither the LEC's ability to sustain a price increase in the market, nor a customer's ability to substitute alternative services, depends in any way on the

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73 Schankerman (at 10) explains that contestability of product markets makes predation ineffective, even if there is market power over facilities, provided interconnection is available.

74 As explained *supra*, interstate switched access is structured in such a way that the rate access customers pay for "loops", the CCL, is applied to the same demand units as the rate for local switching.

"jointness" of the LEC's production technology.[75] Therefore, the nature of the LEC's production should not be a factor in defining relevant markets.

D. The Commission should establish simple competitive criteria, based on supply and demand responsiveness.

There was broad support from commenters concerning the use of measures of supply and demand elasticity as criteria for streamlining. However, some parties recommended that the Commission must rely on market share as an indicator of demand responsiveness. As GTE suggested (at 70-71), once the availability of alternative supply has been shown, the purpose of the demand responsiveness showing should be to demonstrate that the customers regard the alternative services as substitutes for LEC services. This should not require a showing that a particular market share has been lost. The *SFNPRM* does not contemplate such a requirement, noting (at ¶143) that a high market share does not necessarily confer market power.

Yet several commenters who have opposed the use of market share measures in their own markets have advocated their application here. AT&T, which has argued strenuously over the years that market share has no relevance to the determination of market power, in these comments (at 17) recommends that a strict market share criterion be established for streamlining of LEC access markets.[76] AT&T goes farther,

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75 Neither is the LEC's ability to cross-subsidize dependent on the degree of "jointness" in production, as Time Warner claims. Nothing about joint production would confer on the LEC the ability to raise one price as a consequence of reducing another. These access prices would be controlled either by the Commission's price caps, or by the availability of alternative supply, neither of which depends on the degree of shared costs in the LEC's production.

76 *See* AT&T Comments, International Competitive Carrier, CC Docket No. 85-107, filed February 24, 1986 at 4, n.6.

advocating a market share standard that is higher than that used in other markets. AT&T does not explain why relative capacity, as recommended by the Merger Guidelines in markets with the characteristics of interstate access, should not be used instead of relative quantities sold.[77]

Similarly, NCTA demonstrates multiple personalities with respect to the use of market share. When discussing the streamlining of LEC access markets, NCTA (at 30) recommends that the Commission should examine market share. Yet when discussing the application of competitive criteria to its constituent's own services, in its recent comments on the possible waiver of the Commission's cable rules for services in Dover Township, New Jersey, NCTA was at pains to emphasize that relative capacity, and not market share, should be considered.[78] Going further, NCTA also explains that effective competition can be provided by competitors with small or zero market shares, and proposes that the Commission should give strong weight to potential competition from firms who could expand their capacity in response to a price increase.[79] NCTA also suggests that cable firms should be deregulated as soon as a competitor is authorized to provide service, even if no competitive service has actually been offered.

The *SFNPRM* noted (at n.207) that the measure of supply elasticity should include potential capacity that could readily be added by competitors in response to a

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77 For a discussion of the Guidelines and their application, *see* Schmalensee and Taylor II at 24-25. For a discussion of an addressability test as the practical way of measuring relative capacity, *see* GTE Comments at 64-69.

78 *See* NCTA Comments in the matter of Waiver of the Commission's Rules Regulating Rates For Cable Services, CUID Nos. NJ0213 and NJ0160, December 13, 1995 at 13. ("NCTA Dover").

79 NCTA Dover, Attachment by Economists Incorporated at 1-5.